ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Wyland	Analyst:	Jeff Garnier	Bill Number:	AB 2328
Related Bills:	See Legislative History	Telephone:	845-5322	Introduced & Amended Date:	Feb. 19, 2004/April 1, 2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: S Corporations/Carryforward of Net Operating Loss and Tax Credits/Conformity /Accrual Method

SUMMARY

This bill would provide limited tax relief for corporations required in 2002 to be "S" corporations for state purposes. In addition, this bill would conform to the current federal accrual method of accounting rules.

SUMMARY OF AMENDMENTS

The April 1, 2004, made technical amendments to the bill. This is the department's first analysis of the bill.

PURPOSE OF THE BILL

It appears the purpose of the bill is to provide tax relief for corporations that were required under AB 1122 to be an "S" corporation for state purposes by permitting any net operating losses (NOLs) or tax credits generated while a "C" corporation to be use after the conversion to an "S" corporation.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. The provisions relating to net operating loss (NOL) carryovers from a "C" year to an "S" year and the "last-in, first-out" (LIFO) recapture tax apply to taxable years ending on or after December 31, 2001. The provisions affecting credit carryovers from a "C" year to an "S" year and the use of the accrual method of accounting apply to taxable years beginning on or after January 1, 2003. The provision changing the effective date of the "S" corporation election for state purposes to the federal "S" corporation election date applies the same date as the date of the federal election.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Department staff is available to assist with amendments to resolve the implementation, technical, and policy concerns discussed in this analysis.

ANALYSIS

Provisions Affecting "S" Corporations

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Gerald H. Goldberg	4/12/04
_______ N	_______ OUA	__X__ PENDING		

FEDERAL/STATE LAW

Corporations are either classified as a general "C" or a small business "S" corporation. "C" corporation income is taxed first at the corporation level and another level of tax is imposed when corporate profits are distributed in the form of a dividend to the shareholder. Generally, the taxable income of an "S" corporation is taxed only at the shareholder level, rather than at the corporation level, regardless of whether such income is actually distributed.

For taxable years beginning on or after January 1, 1987, California conforms to the federal "S" corporation provisions, with specified exceptions. One important difference from federal law is that California still subjects the income of an "S" corporation to a 1.5% corporate level tax. For taxable years beginning before January 1, 2002, a federal "S" corporation could elect to be a "C" corporation for California purposes. Beginning in 2002, AB 1122 (Stats. 2002, Ch. 35) requires a corporation with a valid "S" corporation election for federal income tax purposes to be an "S" corporation for California income tax purposes. AB 1122 designated the election date for California purposes as the first day the corporation was required to be an "S" corporation for California purposes.

As stated above, California law, in addition to the pass-through of the "S" corporation's income, deductions, and credits to its shareholders, specifies that an "S" corporation continues to be subject to the franchise tax, in an amount equal to the greater of the minimum tax ($800) or 1.5% of its net income for the taxable year. Credits are allowed against this corporate level tax in an amount equal to one-third of the amount otherwise allowable under the Corporation Tax Law. An "S" corporation is not subject to the alternative minimum tax. "S" corporations are allowed net operating losses (NOL) at the entity level, which can be carried forward as deductions against the income subject to the 1.5% "S" corporation tax.

Under federal and state law, "S" corporations are subject to the built-in gains (BIG) tax and the LIFO recapture tax. These corporate level taxes only apply to "S" corporations that were formerly "C" corporations. The BIG tax is assessed on recognized gain from the disposition by an "S" corporation of an asset that can be attributed to the period when the corporation was a "C" corporation. Under California law, these taxes are assessed at the rate applicable to "C" corporations (8.84%).

The BIG tax is designed to apply the "C" corporation tax rate to tax benefits (e.g., depreciation) and appreciation properly belonging to the corporation's "C" years. The BIG tax applies for 10 years after the "C" corporation becomes an "S" corporation. For California purposes the 10-year period begins on the date of the corporation's election to be an "S" corporation for California purposes or the first day of the taxable year the corporation becomes an "S" corporation under the provisions of AB 1122 discussed above. Because prior to AB 1122 a corporation could be a federal "S" corporation and a California "C" corporation, the 10-year period may be different for federal and state purposes.

The LIFO recapture tax applies to corporations that used the LIFO method of inventory accounting on the last day of its "C" corporation tax year (and, therefore, before its first "S" corporation year). The tax is assessed on the difference between the basis of the inventory computed under the LIFO method and the first-in, first-out (FIFO) method of inventory on the last day of the corporation's last "C" year. This difference represents book or paper deductions taken during "C" corporation tax years. Special rules spread the LIFO recapture tax so that it is paid in four equal annual installments. For federal purposes the LIFO recapture tax generally applies to corporations electing to become an "S" corporation after December 17, 1987. For California purposes the LIFO recapture tax applies to corporations that become an "S" corporation on or after January 1, 1989.

Federal and state law does not permit an NOL generated in a “C” corporation tax year to be carried over to an “S” corporation tax year. Any NOL generated in a “C” year is applied against and reduces the BIG, thus reducing the BIG tax. (Note: All NOL deductions have been suspended for the 2002 and 2003 taxable years.)

Federal and state laws provide for various credits that can be carried over to later tax years. Credits generated in a “C” corporation tax year and carried over to an “S” corporation tax year receive different treatment under federal and state law. Under federal law, credits from a “C” year carried over to an “S” year can only be used to reduce the BIG tax. Under state law, credits from a “C” year carried over to an “S” year are reduced to 1/3 of the original carried over amount and applied against the state’s “S” corporation’s measured tax rate of 1.5%.

<u>THIS BILL</u>

For "C" corporations required to be an “S” corporation for state purposes under the provisions of AB 1122, this bill would make the following changes:

- For purposes of the BIG tax, change the California “S” election date from the first day of the taxable year beginning in 2002, to the federal ”S” election date. Because the provisions of AB 1122 apply to corporations that were federal “S” corporations prior to January of 2002, the federal election date will always be earlier than the first day the corporation became an “S” corporation for California. In the case of corporations that were federal “S” corporations prior to 1993, they will never be subject to the California BIG tax.

- Exempt corporations that became “S” corporations under AB 1122 from the LIFO recapture tax.

- Allow NOLs generated in a “C” corporation tax year to be carried forward to an “S” corporation tax year under the NOL provisions in effect for the year the NOL was generated. For example, 55% of an NOL generated in 2001 would be allowed to be taken in 2004. The provision permits the NOL to reduced taxable income for purposes of 1.5% “S” corporation tax and also be pass through to the shareholder.

- Allow 100% of credits generated in a “C” corporation tax year to be applied against the “S” corporation measured tax of 1.5%. The amount of the credit available for taxable years beginning on or after January 1, 2003, would be the credit carry forward amount as of the last day the corporation was a “C” corporation, minus the amount of the credit used in the “S” corporation’s 2002 tax year. Thus, the credit would not be reduced to one-third. The individual credit’s rules in effect the year the credit was generated would apply.

- Change the “S” election date designated by AB 1122 from the first day of the corporation’s taxable year beginning in 2002, to the same date as the federal “S” election date.

Limitation on Use of Non-Accrual Experience Method of Accounting

FEDERAL/STATE LAW

Under federal law, an accrual basis taxpayer generally must recognize income when all events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services that, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Generally, a cash method taxpayer is not required to include an amount in income until received. A taxpayer generally may not use the cash method if purchase, production, or sale of merchandise is an income-producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts exceed $5 million. An exception to this $5 million rule is provided for qualified personal service corporations. A qualified personal service corporation is a corporation (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed $5 million.

The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) changed federal law to provide that the non-accrual experience method of accounting is available only for amounts to be received for the performance of qualified services and for services provided by certain small businesses. Amounts to be received for all other services are subject to the general accrual method rules regarding inclusion in income. Qualified services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. As under prior law, the availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Under a special rule, the non-accrual experience method of accounting continues to be available for the performance of non-qualified services if the average certain annual gross receipts of the taxpayer (or any predecessor) does not exceed $5 million. Various rules apply to the calculation of the $5 million limitation and the Secretary of the Treasury is required to prescribe regulations regarding the calculation. The provision is effective for taxable years ending after March 9, 2002. Any change in the taxpayer's method of accounting required as a result of the limitation on the use of the non-accrual experience method is treated as a voluntary change of accounting method initiated by the taxpayer with the consent of the Secretary of the Treasury. Any Internal Revenue Code (IRC) section 481(a) adjustment, resulting from the change in accounting method, is to be taken into account over a period not to exceed four years.

California is in conformity with federal law as of January 1, 2001, as it relates to the use of the accrual method of accounting. California law has not conformed to the changes made to the IRC by the Job Creation and Worker Assistance Act of 2002.

THIS BILL

Under the Corporation Tax Law, this bill would conform state law to the Job Creation and Worker Assistance Act of 2002 federal law change with respect to the use of the accrual method of accounting.

IMPLEMENTATION CONSIDERATIONS

The provision allowing NOLs generated in "C" years to offset income earned in "S" years is silent on the issue of NOLs being used to offset BIG. Thus, it is unclear if an NOL may be used twice: once against ordinary income and once against BIGs.

TECHNICAL CONSIDERATIONS

There are 2003 dates in the bill that should be either 2002 or 2004.

LEGISLATIVE HISTORY

AB 1122 (Corbett, Stats. 2002, Ch. 35) provided that a corporation that is a valid federal "S" corporation is an "S" corporation for California purposes.

SB 219 (Scott, Stats. 2002, Chap.807) was a technical clean up bill to AB 1122 and other bills enacted in the 2002 Legislative Session.

AB 1622 (Wyland, 2003) would have allowed corporations that became "S" corporations under AB 1122, and its shareholders, to use any previously incurred net operating losses or tax credits that the former "C" corporation had generated prior to the forced conversion into an "S" corporation. AB 1622 did not move out of the Assembly Appropriations Committee.

SB 1237 (Hollingsworth, 2004) would exempt corporations required to be "S" corporations under AB 1122 from the BIG tax for assets sold or under contract of sale before May 8, 2002 (the enactment date of AB 1122). SB 1237 is in the Senate Appropriations Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

By adoption of federal taxable income as a starting point for the determination of net income, all six states generally adopt the federal accounting methods, including the use of the accrual method.

Based on a limited review, *Florida, Illinois*, *Massachusetts*, and *Minnesota* have not allowed separate "S" corporation elections for at least 20 years. Accordingly, the election date, NOLs, BIG, and LIFO recapture tax law has been the same as federal for the above states for at least 20 years.

Michigan treats "S" corporations as any other business entity for purposes of imposing the "single business tax," which is Michigan's version of a business income tax. Consequently, Michigan's tax law is not comparable to California tax law as it relates to "S" corporation elections.

New York allows a separate election for "S" corporation status. New York uses the date of the New York election. However, New York does not impose a BIG or LIFO recapture tax. New York does not permit NOL or credit carryovers from "C" to "S" years.

A cursory review was done of all other states. In addition to New York, only Arkansas allows separate "S" corporation elections. Various information readily available to the public was reviewed, including individual state tax forms and websites. Arkansas uses the date of the Arkansas election for purposes of the BIG and LIFO recapture tax. Arkansas does not permit NOL or credit carryovers from "C" to "S" years.

FISCAL IMPACT

The bill would require the department to process an unknown number of claims for refund or tax due amended returns.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Projected revenue losses are as follows (assumes enactment after 6/30/04):

Fiscal Year	2004-2005	2005-2006	2006-2007
Elimination of Built-in Gains (BIG) Tax	Losses not exceeding $1.5 million	Losses not exceeding $500,000	Losses not exceeding $500,000
Exempt corporations from the LIFO recapture tax	Losses not exceeding $1 million	Losses not exceeding $300,000	
NOL Carryover from C Corp to S Corp and shareholders	Losses not exceeding $600,000	$1.2 million loss	$1.2 million loss
Credit Carryover from C Corp to S Corp	Losses not exceeding $500,000	Losses not exceeding $250,000	Losses not exceeding $250,000
TOTALS (order of magnitude)	$3.6 million loss	$2.2 million loss	$2.0 million loss

Any possible changes in employment, personal income, or gross state product that might result from this measure are not taken into account.

Revenue Discussion

Since a corporation can postpone the sale of assets beyond the 10-year recognition period so as not to become subject to the built-in gains tax, it is not possible to determine the number of corporations that will become subject to the BIG tax as a result of the mandatory conversion to an "S" corporation. Currently only 0.3% of all "S" corporations report BIG tax with an average BIG tax liability of approximately $26,000. This equates to approximately $294,000 of built-in gains per corporation.

For purposes of this analysis, it is assumed that the BIG issue would affect approximately 1,300 "S" corporations. If 1% would be subject to the BIG tax annually over the next 10 years, this would impact less than 15 corporations each year. Assuming an average BIG tax of $26,000 and average built-in gains of $294,000, the elimination of the BIG tax would result in minor (under $500,000) revenue losses annually. The first fiscal year 2004-05 includes three years of revenue losses.

Based on available data, the total LIFO recapture tax is not expected to exceed an average of $300,000 annually. The first fiscal year 2004-05 includes four years of revenue losses.

NOL carryover from "C" corporations to "S" corporations and shareholders -- Based on available data, it is estimated that the utilization of NOL carryovers from the "C" corporation to the "S" corporation is expected to result in a revenue loss of approximately $1.2 million annually over a period of five years.

Credit carryover from "C" corporations to "S" corporations -- Available information indicates that most tax credits are applied in the current year, resulting in a negligible carryover balance. Therefore, allowing 100% of the carryover credits from the "C" corporation to be used by the "S" corporation is expected to result in negligible revenue losses, less than $250,000 annually. The first fiscal year 2004-05 includes two years of revenue losses

POLICY CONCERNS

The bill would allow tax relief for some taxpayers and increase taxes for others for prior tax years. The bill fails to include a public purpose statement for retroactively reducing and increasing taxes.

The bill conforms to the federal treatment of the accrual method of accounting under the Corporation Tax Law, but neglects to conform under the Personal Income Tax Law. Thus, this bill would provide differing treatment based solely on classification, business type, or business organization.

The changes to the NOL and credit carryovers and non-applicability of the LIFO recapture tax makes California law out of conformity with federal law. Thus, this bill would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

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